

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NORTH CAROLINA

U.S. BANKRUPTCY COURT
WESTERN DISTRICT OF NC

In Re:)	Case No. 97-50105-11 P 2:17
)	Chapter 11
HWC LIQUIDATING COMPANY,)	
)	
Debtor(s).)	
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HWC LIQUIDATING COMPANY, f/k/a)	Adversary Proceeding
HICKORY WHITE COMPANY,)	No. 97-5025
)	
Plaintiff(s),)	
)	
v.)	
)	
CENTURY FURNITURE INDUSTRIES, INC.)	
and PATRICK, HARPER & DIXON, LLP,)	
)	
Defendant(s).)	
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FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

This matter is before the court on non-jury trial of this adversary proceeding to determine the parties rights pursuant to their Asset Purchase Agreement (the "Agreement"). The court has concluded that defendant Century Furniture Industries is entitled to recover the sum of \$547,134.00 from the escrow account held by Patrick, Harper & Dixon; and further is entitled to an unsecured claim in the amount of \$ 67,778.33 in the bankruptcy case of plaintiff HWC Liquidating Company. A detailed summary of the computation of this award is attached as Appendix A. In support of its conclusion, the court makes the following findings of fact and conclusions of law:

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BACKGROUND AND STATEMENT OF THE CASE

1. HWC Liquidating Company is the successor of Hickory White Furniture Company (together they will be referred to as HWC). HWC was in the business of manufacturing furniture. Part of its business was the Chaircraft Division through which it manufactured chairs for contract sales primarily to the hospitality and health care industries. HWC is the debtor in this Chapter 11 bankruptcy case, which was filed in 1997. Century Furniture Industries is a manufacturer of furniture.

2. HWC and Century entered into an Asset Purchase Agreement dated November 22, 1995, whereby Century bought all of the assets of HWC's Chaircraft Division. The Agreement did not state a specific purchase price. Rather, the transaction was closed based on an estimated purchase price. Century paid part of the estimated purchase price directly to HWC and deposited the balance in an escrow account that was established pending determination of the final purchase price. The escrow account is maintained by Patrick, Harper & Dixon, Century's attorneys.

3. Pursuant to the Agreement, the parties dispute only the purchase price of Chaircraft's inventory. The Agreement provided for the price of the inventory to be the lower of cost or market value subject to a specific formula based on items on hand as of the closing. The parties' dispute here involves application of the pricing formula in valuing the Chaircraft inventory. HWC

contends the purchase price of the inventory should be \$1,802,413.00. Century contends the price should be \$1,016,881.00.

4. The escrow account established by Century was created pursuant to three separate provisions of the Agreement: \$383,167.00 was deposited for unresolved inventory valuation issues; \$138,967.00 for accounts receivable collection issues; and \$25,000.00 for environmental liability issues. The total principal balance in the escrow account is \$547,134.00. (The escrow account is an interest bearing account, so the actual balance in the account at the time it is disbursed pursuant to this Order will be greater than the total principal balance reflected in this Order. The interest, however, should not be considered in the award in this case).

5. This adversary proceeding is the parties' effort to resolve disputes between HWC and Century over determination of the final purchase price pursuant to the Asset Purchase Agreement. There are three categories of disputes between HWC and Century: (1) valuation of the purchase price of Chaircraft inventory; (2) warranty and payables claims; and (3) miscellaneous claims relating to trademark registration and computer rental.

6. The Agreement contained a dispute resolution mechanism requiring referral of disputes to a third party. The parties have agreed to forego that procedure and to allow the court to resolve the matters raised in the pleadings. Each of the issues in dispute was vigorously contested, and each issue had substantial evidence

on both sides. Given that each side met its burden of production of evidence and that the factual contentions largely do not involve credibility issues, the court has attempted to determine which of the two approaches on each issue is more likely than not the appropriate one. In addition, the court has attempted to determine the fair price for the Chaircraft inventory and to resolve the other issues based upon the preponderance of the evidence standard. Set out below are the facts that the court believes support its conclusions.

THE ASSET PURCHASE AGREEMENT

7. The Asset Purchase Agreement was executed November 22, 1995, and the transaction was closed December 28, 1995. The formula for calculating the price of the inventory provided that Century would pay a percentage of the lower of cost or market value, calculated on an item by item basis, for each item of inventory using generally accepted accounting principles. The percentage factor to be applied to an item was determined by two factors--the type of item and sales information for the item. The Agreement provided for two types of items: "items carried in the current catalog" and "'D' type special" items. For items carried in the current catalog, four quantity categories determined the percentage of the value to be paid. These four categories were determined by current orders and sales history and provided a formula for some value to be placed on items in excess of current

orders (but within the year's actual sales history). For "D" type items, Century was to pay only for those quantities represented by written customer orders. The Agreement also established several other rules: items not of first quality would have no value; certain fabric would have no value; and samples and mock-ups would have no value.

DETERMINATION OF ISSUES IN DISPUTE

8. There are three categories of issues to be resolved in this adversary proceeding: (1) Issues relating to the valuation of Chaircraft inventory: This category includes determination of whether Century is bound by HWC's determination of value, definition of the scope of inventory included in the Agreement's term "current catalog," and the proper valuation of a number of separate types of inventory. (2) Warranty and payables claims: These issues relate to warranty claims paid by Century for items sold prior to the closing and to payment of other pre-closing nonwarranty claims. (3) Miscellaneous claims relating to Century's rental of HWC computer equipment and to Century's re-registration of HWC's Chaircraft trademark.

INVENTORY VALUATION ISSUES:

A. Dispute Resolution Procedure

9. The Agreement established a procedure for determining the price of the inventory through which HWC was to compute the value of the inventory, subject to audit by Century, and any dispute

is no indication in the Agreement that "audit" was to have any meaning other than its common meaning (which is not so limited as HWC contends). The Agreement clearly contemplates that the "audit" would result in a "dispute in regard to the determination of value." Further, HWC's Controller referred in some notes to Century's process of determining value and its "inventory audit." The broad definition of "audit" is reinforced by the context of its use--the Agreement involves the determination of the purchase price in a negotiated sales transaction and not a year-end audit of financial statements. In such context, it is reasonable to expect that Century's "audit" of HWC's inventory valuation would involve its own determination of value.

12. HWC's narrow interpretation of the term "audit" is countered by the fact that its determination of the inventory valuation submitted to Century was incomplete and inaccurate. The Agreement called for the "completed inventory valuation" to be submitted by HWC to Century by a date certain. In fact, HWC's determination left substantial valuation to be made initially by Century and contained substantial misclassification of inventory items. So, HWC itself did not strictly comply with the Agreement. Further, HWC's application of the formula was improper in a number of ways. Specific improper applications are noted below. Generally, however, HWC's calculations were based in large part on gross historical factors not necessarily related to actual inventory cost. Consequently, Century's independent determination

of the value of the inventory was necessitated in part simply to complete the computation and also to apply properly the formula established in the Agreement.

13. Finally, HWC's narrow interpretation of "audit" is belied by the fact that, prior to litigation, the parties acted on the basis that Century's valuation complied with the procedure set out in the Agreement. Century timely submitted its outside accountant's analysis to HWC, and the parties met to discuss the issues Century raised. HWC's Controller referred to Century's submission as the "Inventory Response by Century." That document identifies each of the issues that are now in litigation. The parties undertook to resolve the issues identified and to settle on an agreed valuation of the inventory. It was not until after those efforts broke down that HWC first contended that Century had not complied with the Agreement and was bound by HWC's determination of value.

14. The common meaning of the term "audit," the language of the Agreement, and the parties conduct all demonstrate the appropriateness of Century's analysis of the Chaircraft inventory and its valuation using approaches different from that used by HWC. Century complied with the procedure established by the Agreement and is not bound by HWC's determination of inventory value.

B. Current Catalog Items v. "D" Items

15. The Agreement provides that the following inventory was to be valued based upon a rate of sale: "raw materials, (except "D"

type special raw materials), work in process and finished goods carried in the current catalog...." [Agreement para. 2(e)]. An item must be "carried in the current catalog" to receive a valuation in excess of orders outstanding at the closing date. The parties differ greatly over the meaning of "current catalog." Century contends that the phrase includes only the items contained in Chaircraft's published catalog. HWC contends that the phrase also includes items that were available as ongoing "program chairs" sold to specific customers, chairs manufactured for other chair manufacturers (OEM accounts), and style D-5251/1243 chairs. HWC included all three such items in its inventory price calculations.

16. The court finds that the phrase "carried in the current catalog" is limited to those items that are contained in Chaircraft's published catalog. That meaning is consistent with the plain meaning of those words and the Agreement. Although the issue is not absolutely clear, there is insufficient evidence to demonstrate that the parties intended some meaning to this phrase other than its common meaning. Consequently, the preponderance of the evidence demonstrates that Century's interpretation of the phrase "carried in the current catalog" is the proper one.

17. The term "catalog" has a common meaning, and there is no indication in the Agreement that it was intended as a term of art. Chaircraft in fact published a "catalog" which fit that common meaning. This catalog was a bound collection of drawings and descriptions of chairs offered for sale. The other items HWC seeks

to include in the meaning of "current catalog" are all items that fall into other categories and are not part of a "catalog." While those items were part of Chaircraft's ongoing business, there was no evidence that Chaircraft itself had ever considered that ongoing business as part of its "catalog."

18. HWC argued that Century did not understand the contract furniture business, and by implication, that if it had it would have known that Chaircraft's regular, on-going business involved more than the items contained in its catalog. But, that argument misses the mark. The Agreement provided that inventory was divided into two categories: current catalog items (offered to all customers generally) and other items (largely items designed for one customer only). In the absence of agreement on a special definition, the term "current catalog" should have its common meaning.

19. HWC also points out that there were actually two catalogs (hospitality and healthcare), but the Agreement was written in the singular--"catalog." The court cannot infer from that discrepancy that the term "catalog" has the expanded scope HWC contends. The variance appears rather to have been an error borne of the fact that Century did not learn about the second healthcare catalog until after Century had drafted the Agreement.

20. Finally, HWC also argued that the term "catalog" was ambiguous and that since it was drafted by Century it should be construed against Century and in favor of HWC. While it may be

true as a general rule that ambiguities are construed against the drafter, there are a number of reasons why that principle should not apply here. First, these contracting parties are sophisticated, commercial entities who negotiated on equal footing. Second, this language was accepted by HWC without negotiation or comment. Third, and most important, the term is not ambiguous--it means just what it is commonly understood to mean. The mere fact that HWC contends it includes much more than that does not make the term ambiguous. In fact, as noted specifically below, the parole evidence and the context of the Agreement confirm the common meaning of "catalog" applied by Century.

21. The total amount Century claimed to have been improperly classified as "current catalog" inventory is \$397,068.00. HWC contends that inventory for (1) D-5261/1243 chairs, (2) program accounts, and (3) OEM accounts should be added back into the purchase price. The court finds and concludes that these categories are properly classed as "D" items and that this inventory should have no value pursuant to the Agreement.

(1) D-5261/1243 Chairs

22. Several months prior to the Agreement, Chaircraft bid on an order for 3,530 custom desk chairs. It designated the chairs with a style number "D-5261." To cover this order, Chaircraft contracted to purchase 3,530 of these chairs from a Slovenian supplier. However, Chaircraft received an order for only about 1,500 of the chairs. After execution of the Agreement, but prior

to the closing, Chaircraft took delivery of the remaining D-5261 chairs for which it had no buyer. Except for random sale of eight such chairs, over 2,000 of the D-5261 chairs remained in Chaircraft's inventory at closing. At some point, Chaircraft changed the style number to 1243, made the chairs available for sale, and intended to include them in a future catalog. The chairs were not part of the "current catalog" either under designation as D-5261 or as 1243. HWC contends that this inventory should receive a value of \$72,631.94.

23. The D-5261/1243 chairs clearly fall within the category of "D" items. They were originally designated as such by Chaircraft. Though they may have been offered for sale and intended for a future catalog, they are not "carried in the current catalog" so as to qualify for valuation pursuant to the Agreement. These were speciality chairs acquired for a single purchaser. In addition, there were no outstanding customer orders for the chairs at the time the Agreement was signed. There were no unit sales of the 1243 chairs in 1995, so there was no rate of sale to support inclusion in the purchase price.

24. HWC offered the evidence of its computer programmer to indicate that it had been misled into segregating these chairs for retention by Century. That evidence is inconclusive at best. The testimony was rebutted by Chaircraft's President, and there was no other evidence to support it. Moreover, there was no foundation for how HWC's computer programmer could have been certain of the

identity of the chairs; and the evidence indicates that she confused the D-5261 chairs with a similar style D-5297 (which did have a backlog at the time).

25. For all of the above reasons, no value should be assigned to the inventory of D-5261/1243 chairs.

(2) Program Accounts

26. A significant part of Chaircraft's business was contract and custom manufacturing of chairs for specific customers. Chaircraft manufactured chairs designed exclusively for a number of restaurant chains including Red Lobster, Olive Garden, Chili's, Steak and Ale, and IHOP. These chair styles were exclusive to the contracting purchaser and were not presented in any catalog. HWC valued the inventory for such chairs using the formula for items "carried in the current catalog" on the basis that the chairs were regularly sold to particular customers. The court finds to the contrary because (a) these items are clearly not contained in either of the Chaircraft catalogs; and (b) the Agreement defined these accounts as "D" items. Consequently, inventory for program accounts should be classified as "D" items and given no value. HWC had valued this inventory at \$83,797.00.

27. Chair styles for "program accounts" were not carried in Chaircraft's catalog. They were not offered for sale to customers in general, but were manufactured for only one customer pursuant to a separate contract. The simple fact is that these items were not

listed in the catalog, but rather were listed in separate price lists and contracts.

28. Prior to the Agreement, Chaircraft's practice had been to use the designation of "D" for a chair style that was a specially designed style. It was not a term used regularly in the furniture industry. However, the term was used in the Agreement to include program accounts. In fact, irrespective of Chaircraft's prior use of the term, the Agreement specifically defines "D" type items: "this category would include special orders for Red Lobster, Olive Garden, and similar customers." [Agreement para. 2(e) (emphasis added)].

29. The evidence demonstrates that all of the program accounts fall within the definition of "D" type items described in the Agreement. Red Lobster and Olive Garden are specifically designated in the Agreement, and the other "similar customers" include Chili's, IHOP, and Steak and Ale. These accounts were all similar in the way Chaircraft handled their pricing, marketing, accounting, and billing; and in their exclusivity of style. In addition, Exhibit 12 showed that Chaircraft itself categorized all of these accounts as "D" type items. And, HWC's Controller gave Century a list of accounts that were "like Chili's" (the largest contract at the time), and these accounts included Red Lobster, Olive Garden, Steak and Ale and IHOP.

30. HWC contends that the two program accounts specified in the Agreement--Red Lobster and Olive Garden--were distinct from the

others because there was no current contract for their chairs. Given all of the evidence to the contrary, the court finds no distinction intended based upon the current activity of the particular customer. Rather, the distinction between "catalog" and "D" type items in the Agreement appears based on reliability of repeat orders. The items in the catalog were available to a large universe of buyers, whereas the items for program accounts were subject to the fancy of only one customer. That is a most reasonable distinction in an agreement for the purchase of inventory--which will have value to the buyer only if future orders are made.

31. For the foregoing reasons, the court finds and concludes that inventory for the program accounts was "D" type items and should have received no value in the price calculation.

(3) OEM Accounts

32. Chaircraft manufactured chairs for other chair sellers (or "OEM" customers) that HWC contends should be considered as "current catalog" items. For example, Chaircraft manufactured chairs for Hooker Chair company. HWC contends that these items were "carried in the current catalog" because they were regularly sold and should have received a value of \$8,726.00. This contention is not supported by the evidence.

33. The chairs produced for OEM accounts were not listed in Chaircraft's catalog. In fact, they did not carry the Chaircraft name. Chaircraft's President described the OEM chairs as one-time

type orders, and there could be no expectation of reliable repeat orders. For these reasons, the court finds that inventory for OEM accounts must be treated as "D" type items and given no value.

C. Waste Factor

34. HWC and Century differ on the proper calculation of the waste factor. Part of the cost of an item of inventory is the material wasted in the manufacturing process. In valuing Chaircraft's inventory, HWC used a waste factor of 20%. This number was derived from the figure historically used in Chaircraft's financial statements. The court finds that Century's waste factor of 7.5% more accurately contributes to the calculation of a fair value of the inventory. Application of Century's waste factor reduces the inventory valuation by \$10,299.00.

35. The historical waste factor used by HWC was not supported by any actual substantiation. The closest HWC came to substantiating the 20% waste factor was its assertion that it had used that factor in ordering materials and had not experienced any accumulation of surplus materials. Without identifying and negating other possible explanations for the lack of surplus material, HWC's postulate is not persuasive. In fact, HWC's own outside expert expressed no opinion on the reasonableness of the 20% waste factor. Further, the fact that HWC had used that factor over the years for financial reporting and that it met generally accepted accounting principles for that purpose is not conclusive. The touchstone for those accounting principles is consistency from

year-to-year; whereas in this transaction, the relevant inquiry is the actual value of the inventory. In fact, the Agreement specifically provides that "[m]ethods used [for valuing inventory] may or may not be consistent with previous methods used...." [Agreement para. 2(e)].

36. Century's accountants endeavored to determine the actual waste incurred in the manufacturing process. The 7.5% waste factor Century used is derived from Chaircraft's own records of actual waste incurred (although it is an estimate derived from several component factors). This empirical evidence supports the 7.5% waste factor used by Century.

37. The court finds Century's approach reasonable and the waste factor it used to be the more appropriate one. The purchase price should be reduced by \$10,299.00 on this account.

D. Labor and Overhead on Purchased Parts

38. In calculating the purchase price, HWC assigned labor and overhead factors to certain inventory that was purchased from outside suppliers in a finished condition. Application of those factors was improper because no manufacturing labor and overhead costs were associated with that finished inventory. As to those items purchased in a finished condition, the purchase price established the total manufacturing cost. As a result, the purchase price should be reduced by \$57,923.00.

E. Excess Plant Capacity

39. Century asserted that Chaircraft had underutilized plant

capacity and, as a result, that HWC should have reduced its inventory valuation by \$43,591.00. Century's bases for that assertion are not well founded, and the court finds no adjustment necessary for excess plant capacity.

40. Century's conclusion that there was excess capacity is based in part on statements in the "prospectus" prepared by the broker who was marketing Chaircraft. That information is superficial on its face and is not probative. Century also bases its assertion on inferences drawn from Chaircraft's increased purchase of finished goods. While that did occur, it also appeared that sales had increased in the same period, so there was not necessarily a significant decline in plant production as a result of the purchase of finished goods.

41. Generally accepted accounting principles provide for reduction of inventory cost only for "abnormal" excess plant capacity. Century offered no evidence to support a finding of excess plant capacity of that nature. Consequently, the purchase price should not be reduced on account of excess plant capacity.

F. Cost Adjustment for Work In Process

42. In valuing Chaircraft's inventory, it was necessary to devise a formula for valuing chairs that were in the process of being manufactured at the time of closing. HWC and Century differed on determination of the proper formula for valuing work in process. HWC valued all its finished goods inventory and certain partially completed items (or work in process) at a percentage of

the selling price. The court finds that this method is improper because the Chaircraft selling price is not necessarily related to cost. The Agreement required valuation of inventory based on the "lower of manufactured cost or market." [Agreement para. 2(e)]. Although it may have some flaws, the court finds Century's method of calculating the value of work in process to be more reasonable than HWC's and to yield a fair valuation of that inventory. Using Century's formula would require a reduction of the purchase price by \$63,252.00.

43. HWC's method of valuing work in process based on the selling price of items is artificial and unsubstantiated. HWC derived its percentage factor by comparing cost of sales to sales as contained on its financial statements. It offered no evidence that the percentage (derived from sales of finished goods) had any relation to unsold finished and partially finished goods. The percentages used had not been verified by any recent data. And, HWC offered no evidence of the actual costs of the work in process inventory.

44. Century used a cost build-up method of valuing work in process inventory. Century's calculations were made based on the actual costs included in the work in process. There were three categories of work in process that Chaircraft used--finished goods, WIP 70%, and WIP 62%. Century's accountant based his calculations on the standard cost sheets that had been prepared for each item by Chaircraft's engineers and cost accountants. These sheets

contained the cost of all materials, labor, and overhead for each chair. Century's methodology was confirmed in part by the fact that it yielded essentially the same result that HWC had calculated for finished goods (the only component that could be calculated from the financial statements). The court finds that Century's calculations show the following adjustments: WIP 70% = \$61,836.01; WIP 62% = \$2,096.79; and finished goods = (\$681.16).

45. HWC's outside expert accountant criticized Century's accountant's methods because he varied his methodology for different WIP categories, he extrapolated from samples in some instances, and for other reasons. However, the court finds that Century's variations in methodology were dictated by differences in the circumstances and were reasonable; that its samples, though not random, were quite large (e.g., 63% for WIP 70%); and that its efforts were reasonably directed at determining the actual value of the work in process inventory.

46. Though perhaps imperfect in some regards, Century's calculation of the work in process inventory appears reasonable and fair. It is certainly a more accurate determinant of the actual value of the WIP inventory than HWC's historical, but unsubstantiated, approach. Consequently, the purchase price should be reduced by \$63,252.00 on this account.

G. Cost Adjustment For Purchased Frame Stock

47. Century's accountant discovered that HWC's valuation for frame stock inventory it had purchased was higher than the cost

indicated on its cost sheets. Neither party was able to compute this valuation by the most accurate method--tracking down, retrieving, and analyzing each invoice for purchased frame stock on hand. HWC offered no substantiation for its estimate used in calculating the purchase price. Century performed an analysis with respect to the frame stock inventory as similar to its valuation of work in process. For the reasons noted above, Century's approach is the preferable one under the circumstances. Consequently, the purchase price should be reduced by \$13,066.00 on this account.

H. Obsolete Inventory

48. Calculation of the purchase price required a determination of which items of certain inventory were obsolete and of no value. HWC was unable to perform rate of sale calculations for certain generic items of inventory including trim, seat boards, fabric, filling, finishing and packing material. HWC agreed that Century would compute the value of such items, and the parties further agreed that full value would be given to items bought within one year prior to closing (and no value for items older than that). Century's valuation would require deduction of \$190,993.00 from the purchase price.

49. With respect to trim and fasteners and fabric, Century researched the Chaircraft invoices for such items. It tested a sample representing about one-third of the non-fabric total cost value. (Virtually all of the fabric was obsolete). Extrapolation of that figure indicated that the inventory value of those items

should be reduced by \$137,417.00.

50. With respect to filling, finishing and packing materials, Century asked Chaircraft employees to indicate which items were still being used. That process indicated a reduction of \$22,761.00.

51. The cane had a zero value. That required reduction of the valuation by \$1,970.00.

52. HWC has asserted some criticisms of Century's methodology, but it has offered no better alternative. HWC largely yielded this part of the valuation process to Century. Century's procedures appear reasonable and designed to apply the parties' agreements and to reach a fair valuation. Consequently, the purchase price should be reduced by \$190,993.00.

I. Mathematical Errors

53. HWC made a \$9,410.00 mathematical error regarding the cost of trim and fasteners. Adjustment for that error is not disputed.

J. Ritzen 188G Reclassification

54. HWC contends that \$42,416.00 should be added back to inventory on account of the cancellation of an order by a customer, Adamson Ritzen, Inc. Ritzen submitted a purchase order for 964 188G chairs about two weeks prior to the closing. This order was booked as an account receivable and accounted for as such in the closing. However, the order was canceled, and the chairs were never shipped. Consequently, the "receivable" was put back to HWC

pursuant to the Agreement. HWC contends that the cost of these 188G chairs should have been added back to the inventory valuation. That argument fails because these chairs were second-quality goods not entitled to value.

55. The Agreement provides that "[i]tems that are not first quality will have a zero value." [Agreement para. 2(e)]. Chaircraft's former President described the 188G chairs as second quality chairs (and defective). The "G" denotes that the chairs were manufactured for Chaircraft in Guatemala. They were produced from a lightweight South American wood that was of lower quality than the identical design model 188 chairs manufactured by Chaircraft. In addition, the glue joints in those chairs failed, and the purchaser made a warranty claim. Chaircraft replaced all the chairs that were in place and brought the defective ones back to its plant.

56. Because the 188G chairs were "not of first quality" they are entitled to no value, and there is no basis for adding their cost back to the inventory valuation.

WARRANTY AND PAYABLES CLAIMS:

57. The second major category of issues to be resolved in this adversary proceeding pertains to warranty claims honored by Century and certain accounts paid by Century. Chaircraft sold items prior to the closing for which warranty claims were made after the closing. Century honored those claims in the amount of \$79,381.49 and, as a result, asserts that it is entitled to either

setoff the escrow balances by that amount or in the alternative to be allowed that amount as an unsecured claim in the HWC bankruptcy.

58. Century contends that it is entitled to such a result based on the theory of equitable subrogation. In addition, Century obtained assignments of \$75,376.02 of the warranty claims in an attempt to avoid any doubt about its right to recover. HWC, on the other hand, argues that Century cannot benefit from the doctrine of equitable subrogation in the belief that Century acted as a volunteer. HWC also contends that Century's assignments of the warranty claims were ineffective as a matter of law such that Century is not entitled to any portion of the \$79,381.49 in warranty claims honored subsequent to the closing.

59. The court finds that Century is entitled to \$79,381.49 for warranty claims honored based on a theory of equitable subrogation. Consequently, the court need not address the issue of the effectiveness of the assignments of the warranty claims.

60. As a general principle, equitable subrogation "is an equitable remedy which arises when one person has been compelled to pay a debt which ought to have been paid by another and for which the other was primarily liable." Trustees of Garden of Prayer Baptist Church v. Geraldco Builders, Inc., 78 N.C.App. 108, 114, 336 S.E.2d 694, 697-98 (1985). The trend among courts is to expand rather than to restrict the principle of equitable subrogation such that the doctrine has become "highly favored" and "liberally applied." Boney, Insurance Comm'r v. Insurance Co., 213 N.C. 563,

197 S.E. 122, 125 (1938).

61. One limitation upon the doctrine of equitable subrogation is that it should not be applied in favor of a volunteer, or one who discharges the debt of another despite having no legal or moral obligation to do so or having no real or supposed interest of his own to protect in doing so. Id. However, given the equitable nature of the doctrine, the concept of "volunteer" is an exception that should be narrowly and strictly interpreted. Id.

62. In this case, the parties do not disagree over the fact that Century had no legal obligation to pay the warranty claims at issue. But, Century did have a legitimate interest of its own to protect in honoring the warranty claims. In Nappi v. Nappi Distrib., 691 A.2d 1198, (Me. 1997), the Supreme Court of Maine held that a corporation's payment for the completion of work "in an attempt to support its own reputation and interest, was sufficient to entitle it to be equitably subrogated in [the] case." Nappi, 691 S.2d 1198, 1200 (Me. 1997). In addition, the court recognized that an economic interest may be sufficient to satisfy the standard for equitable subrogation. Id. at 1201 (citing Springham v. Kordek, 55 Md.App. 449, 462 A.2d 567, 569-70 (1983)).

63. Century's payment of the warranty claims was clearly done in an attempt to support its own reputation and to protect its economic interest. Century purchased Chaircraft's assets, including its brand name, and continued to operate as "Chaircraft." As far as the warranty claimants knew, "Chaircraft" was the entity

responsible for the warranty. As a result, Century's failure to honor the warranty claims would in all likelihood have caused it to lose the goodwill, customer relations, and prospect of future business with the claimants. In this respect, Century was compelled to pay the warranty claims to maintain its reputation and to protect its economic interest. Century paid the claims on the same basis and pursuant to the same practices that Chaircraft had when owned by HWC. The claims appear to be valid (HWC offered no evidence to rebut Century's showing of validity). Thus, as a matter of equity, Century is entitled to be subrogated to the warranty claimant's rights and to setoff the \$79,381.49 for warranty claims honored.

64. Century also paid \$14,038.84 for certain of Chaircraft's accounts payable. These payments were valid, and Century acted appropriately in paying them. For the reasons stated above with respect to the warranty claims, Century is entitled to be compensated by HWC for these payments in the amount of \$14,038.84.

COMPUTER RENTAL AND TRADEMARK REGISTRATION:

65. Century agreed to pay \$5,000.00 per month for rental of HWC's computer equipment. It rented the equipment for five months, so HWC is entitled to credit for \$25,000.00. The \$25,000.00 due HWC should be deducted from the adjustments due Century.

66. In the Agreement, HWC warranted the validity of its Chaircraft trademark. However, that trademark was allowed to lapse prior to closing. Consequently, HWC breached its warranty of the

validity of its trademark. Century incurred \$2,500.00 in attorney's fees to re-register the trademark and is entitled to recover that cost as damages for HWC's breach of the warranty.

DISTRIBUTION OF THE ESCROW FUNDS:

67. The final issue to be decided in this adversary proceeding is whether Century has the right to be reimbursed from the non-inventory escrow accounts for the amount it is due pursuant to this Order for inventory adjustments, warranty and payables claims, and trademark registration. As noted above, the Agreement did not state a specific purchase price. Rather, the parties closed the transaction based on an estimated purchase price and established an escrow account pending determination of the final purchase price. The escrow account was established pursuant to three separate provisions of the Agreement: \$383,167.00 was deposited for unresolved inventory valuation issues; \$138,967.00 for accounts receivable collection issues; and \$25,000.00 for environmental liability issues.

68. There is no remaining dispute between the parties under the provisions of the Agreement that relate to the trade receivables and environmental escrows. And, there remains in the Patrick, Harper & Dixon escrow account the sum of \$92,241.00 on account of the receivables and environmental escrows.

69. The issue is whether Century can be paid amounts arising from inventory adjustments (which exceed the inventory escrow) and other claims from the funds remaining from the receivables and

environmental escrows. The court finds and concludes that Century should be paid the remaining balance of the receivables and environmental escrows because those excess escrow funds are Century's property.

70. Parties place property in escrow to remove control of the property from the depositor. Collins v. Norton, 136 Ga.App. 105, 220 S.E.2d 279, 280 (1975). Nonetheless, title "remains in the depositor who surrenders his property to the third party, until all conditions of the escrow are accomplished or it is abandoned and he or another receives the property from the depository." Id. North Carolina law recognizes the principle that title to the deposited funds remains in the depositor until the conditions governing the escrow are met. GE Capital Mortgage Serv., Inc. v. Avent, 114 N.C.App. 430, 442 S.E.2d 98 (1994).

71. In this case, Century placed funds in escrow because at the time of closing the parties estimated the purchase price and were aware that in all likelihood, upon more in depth examination of the inventory value and other issues, adjustments would have to be made to the purchase price. Title to the escrow funds could pass to HWC only upon the occurrence of certain conditions. Implicit in the creation of the escrow accounts is the condition that once HWC has been paid all it is due under the Agreement, it can have no further claim to the escrow. So, title to the remaining escrow balance never passed to HWC, as the condition of its being paid in full by Century had been met.

72. HWC has been paid the full purchase price pursuant to the Agreement. Consequently, it has no rights to the escrow account regardless of the reason for establishing the escrow. The escrow funds remain Century's property. Consequently, Century is entitled to all of the funds in the escrow account established with Patrick, Harper & Dixon.

73. HWC argued at some length that Century was not entitled to a "set off" of the non-inventory escrow funds pursuant to 11 U.S.C. § 553. Based on the findings above, the court concludes that no "set off" should occur here because the escrow funds never became property of HWC or the bankruptcy estate. See Dameron v. Tyler, 155 F.3d 718 (4th Cir. 1998). See also, F.D.I.C. v. Knostman, 966 F.2d 1133 (7th Cir. 1992) (holding that escrowed funds never became part of bankrupt's estate because conditions regarding disbursement of funds to debtor were not met prior to the bankruptcy filing, thereby extinguishing the debtor's interest in the escrowed funds). It could be said that instead a "recoupment" should be allowed. But, the simple fact is that the remaining non-inventory escrow funds are (and have always been) Century's property. Any conclusion to the contrary would result in an unfounded windfall to HWC. Neither HWC nor its creditors are entitled to funds in excess of the proper purchase price pursuant to the Agreement.

CONCLUSION

74. For all of the foregoing reasons, the court has concluded

that Century is entitled to recover \$614,912.33 from the escrow account and from HWC. The total principle balance of the escrow account, \$547,134.00, shall be paid in partial satisfaction of Century's recovery. (The entire balance shall be paid to Century, but the amount attributable to interest shall not reduce Century's recovery). That amount of Century's recovery not compensated by the escrow account, \$67,778.33, should be allowed as an unsecured claim in HWC's bankruptcy case.

It is therefore **ORDERED** that:

1. Century Furniture Industries shall have and recover of HWC Liquidating Company the sum of \$614,912.33;

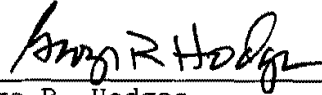
2. Patrick, Harper & Dixon is directed forthwith to pay to Century Furniture Industries the entire balance from the escrow account it holds pursuant to the Agreement dated November 22, 1995, of which \$547,134.00 shall apply toward satisfaction of the award in paragraph 1;

3. Century Furniture Industries is allowed an unsecured claim in the HWC Liquidating Company bankruptcy Case No. 97-50105 (WDNC) in the amount of \$67,778.33;

4. This Order shall constitute and establish Century Furniture Industries' claim in the above referenced bankruptcy case without further filing or substantiation;

5. Century Furniture Industries shall be entitled to all interest earned on the funds in the Patrick, Harper & Dixon escrow account until such funds are paid; and

6. Each party shall bear its own costs of this action.



George R. Hodges
United States Bankruptcy Judge

APPENDIX A

I. Summary of Calculation of Adjustments to Purchase Price

HWC Inventory Valuation	\$1,802,413.00
Adjustments by this Order:	
Items not in the "current catalog"	(397,068.00)
Improper waste factor	(10,299.00)
Improper overhead on purchased items	(57,923.00)
Failure to deduct for excess plant capacity	-0-
Improper estimate of cost of work in process	(63,252.00)
Improper estimate of cost of frame stock	(13,066.00)
Obsolete Items	(190,993.00)
Mathematical errors by HWC	(9,410.00)
Ritzen Reclassification	-0-
Purchase price of inventory per Agreement	1,060,402.00
Purchase price assumed at closing	1,532,668.00
Inventory refund due Century	472,266.00
Inventory escrow to be paid to Century	383,167.00
Amount of inventory refund due Century in excess of inventory escrow	89,099.00

Net other non-inventory claims of Century:	70,920.33
Warranty Claims	79,381.49
Additional Payables	14,038.84
Computer rental due HWC	(25,000.00)
Trademark registration	2,500.00
Total adjustments and claims in excess of inventory escrow	160,019.33
Remaining balance of escrow to be paid to Century (environmental and receivables)	92,241.00
Amount due Century in excess of escrow	67,778.33
II. <u>Summary of Award to Century</u>	
Amount Century is due from HWC	\$614,912.33
Amount credited from escrow funds	547,134.00
Amount allowed as unsecured claim in HWC bankruptcy	67,778.33